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The taxation of multinational banking income: Is the traditional rationale correct?

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This article argues that multinational banks have characteristics which are unique and distinguishable from traditional multinational entities. The first distinguishing feature is the unique nature of the services and consequent products supplied by multinational banks, which are aimed at meeting client global demand. The second distinguishing feature is the non-traditional organisational structure that is adopted. This structure, also designed to meet client global demand, introduces issues previously not recognised in the traditional taxation system, which is designed for the structure of traditional multinational entities. The unique differences between traditional multinational entities and multinational banks means there may be the need for a distinct international tax regime. It is argued that there are "outmoded economic assumptions" upon which the present tax laws relating to multinational banks are based. An examination of the unique nature of multinational banks leads to the conclusion that the appropriate tax treatment of these banks is different from the appropriate tax treatment of multinational entities generally.

1. INTRODUCTION

All multinational entities are subject to specific tax rules which require the distribution of income between the relevant jurisdictions to be determined under the transfer pricing provisions according to an arm's length price. This requirement is a product of both domestic law and tax treaties and is the accepted standard for the allocation of income within a multinational entity. Multinational banks are no exception and therefore must comply with this arm's length requirement. However, it is arguable that multinational banks do not have the same characteristics as a traditional multinational entity. Where this is the case, and the multinational bank does not fit within the traditional multinational entity framework, the problems associated with the application of the transfer pricing regime and the arm's length requirement are exacerbated.

The purpose of this article is to examine whether the underlying rationale for taxing multinational banks in the same manner as their more traditional counterparts is correct. The reason for such an examination is that it may be argued that multinational banks pose

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particularly significant challenges to the current tax regime because of its inadequate jurisdictional (sourcing) and allocation (transfer pricing) rules.[1] The traditional banking business of borrowing and on-lending money creates difficulties from a tax perspective when undertaken in a multinational setting. The difficulties are multiplied when a bank carries out a global trading role.[2]

Within the context of multinational banking, it is argued that there are "outmoded economic assumptions"[3] upon which the present tax laws relating to multinational banks are based.[4] It is argued that the present regime, applicable to multinational banks, lacks the requirements of an equitable tax regime; in particular, the requirement of consistency, distorting capital allocation within the financial markets. That is, the traditional international tax regime governing jurisdiction and allocation is composed of legal concepts and constructs that fail to reflect the economic realities of multinational entities in general[5] and multinational banks in particular.

This article proposes that multinational banks be excepted from the current regime and subject to discrete regulation. This proposition is not normally espoused. Rather, it is generally accepted that new financial instruments are the leading example of the current difficulties in the international tax regime.[6] This new type of market has brought to the attention of tax administrators the discrepancies in the traditional tax regime, highlighting the inability of the regime to deal with modern financial transactions.[7] While this article maintains the former proposition, the latter is not inconsistent and, as such, is acknowledged.

The argument put forward in this article is that the current international taxation rules governing jurisdiction and allocation of income for multinational entities in general are not optimal for taxing multinational banks. As such, it is essential to establish that there are

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[1] Wickham DW and Kerester CJ, "New Directions Needed for Solution of the Transfer Pricing Tax Puzzle" (1992) 5 Tax Notes Int'l 399 at 401. See also Green who explains the problem as follows: "Multinational enterprises can avoid one country's corporate income tax by moving their investment to another country. More significantly, the current international tax system allows multinationals considerable latitude to leave their investment in place but to shift the reported source of income. Multinationals can accomplish this by manipulating the prices that their affiliates charge one another in intercompany transactions or by strategically arranging their financial structures": Green RA, "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Cornell L Rev 18 at 18.

[2] Plambeck CT, "The Taxation Implications of Global Trading" (1990) 44 Bul Int'l Fisc Doc 527. "Global trading" is the practice by financial intermediaries to execute customer orders and to take proprietary positions in financial products in markets around the world and around the clock.

[3] Plambeck, n 2 at 536.

[4] See, eg Bird and Wilkie who suggest that the gap between economic reality and the assumptions underlying the existing international tax system needs to be bridged before the source-residence question can be insightfully considered: Bird RM and Wilkie JS, "Source- vs Residence-Based Taxation in the European Union: The Wrong Question?" in Cnossen S (ed), *Taxing Income in the European Union – Issues and Options for Reform* (Oxford University Press, 2000) p 78.

[5] Graetz MJ, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies" (2001) 26 Brook J Int'l L 1357 at 1417.

[6] Spence I, "Globalization of Transnational Business: The Challenge for International Tax Policy" (1997) 25 *Intertax* 143 at 144.

[7] Alworth JA, "Taxation and Integrated Financial Markets: The Challenges of Derivatives and Other Financial Innovations" (1998) 5 Int Tax Public Finance 507.

fundamental differences between traditional multinational entities and multinational banks. The unique nature of multinational banks is considered to demonstrate how these differences assist in the distortion of the allocation of taxing rights.

This article first considers the background to this issue and establishes the fundamental reason for considering the unique nature of multinational banks. It also considers the role of the multinational bank in a global economy and establishes the two core differences, or distinguishing features, between multinational entities in general and multinational banks, and why they have an impact on taxation, particularly in failing to arrive at a result which reflects economic reality. The article then offers a solution that should be investigated. It concludes that multinational banks are unique in nature. For taxation purposes, therefore, or, more specifically, in order to examine whether the current regime is optimal, resulting in a reflection of economic reality, this article concludes that multinational banks should be considered separately from traditional multinational entities for taxation purposes.

2. THE SIGNIFICANCE OF MULTINATIONAL BANKS FROM A FISCAL PERSPECTIVE

Whether multinational banks undertake traditional banking business or the more innovative and modern business of global trading, they are creating taxation issues that have previously gone largely unnoticed.[8] However, due to an increase in both the emerging taxation issues and the number of multinational banks globally, these problems are now being considered. Initially, the taxation of these banks was not a significant issue due to the small number of multinational banks in existence. Internationally, it was not until 1984 that the Organisation for Economic Co-operation and Development (OECD) specifically addressed some of the substantive transfer pricing issues relating to multinational banks.[9] In July 2008, the OECD issued a report on the attribution of profits to permanent establishments (branches), which updates the issues and situations described in the 1984 report.[10] The 2008 report also deals with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets, which have been such a feature of the global economy in the late 20th century.[11]

The global expansion of multinational banks has had ramifications for domestic jurisdictions. Many jurisdictions have had to address the increase in multinational banking by undertaking legislative changes regarding their regulatory control. Yet, little has been done to consider the tax consequences. Australia is an example of a jurisdiction which has faced this issue. Despite Australia's banking industry undergoing substantial changes aimed at addressing its restrictive policy and encouraging foreign entry into Australia by non-Australian financial institutions, little has been done to consider the taxation consequences

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[8] Plambeck CT, "Transfer Pricing Analysis of Global Trading Operations and Procedural Alternatives" (1996) 74 *Taxes* 1129.

[9] Organisation for Economic Co-operation and Development (OECD), *Transfer Pricing and Multinational Entities – Three Taxation Issues* (OECD, 1984).

[10] OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD, 2008).

[11] OECD, n 10, p 75.

of entry by these banks.[12] Similarly, with this change in policy, Australian banks are entering foreign markets, with little government regard to the taxation consequences of such events. The loosening of regulatory restrictions has led to an increase in foreign banking activity. Along with deregulation, the communications revolution and technological change have had a significant effect on the increased globalisation of financial markets.[13]

The growth of multinational banks, without a consideration of the international taxation rules governing jurisdiction to tax and allocation of income, means there is a very real possibility that multinational banks may not be taxed in an optimal manner. More specifically, the current regime may not be distributing the taxing rights in an equitable manner between the relevant jurisdictions,[14] while simultaneously failing to allow decisions of the international banks to be tax neutral. In this sense, neutrality is viewed as an economic concept and equity is regarded as a legal concept.[15] A neutral tax system is one in which tax rules do not affect economic choices about commercial activities. Neutrality will ideally be across jurisdictions as well as across traditional and non-traditional industries. The primary focus of this article is jurisdictional neutrality, also known as economic efficiency.[16]

An optimal regime also strives to achieve equity between taxpayers. In order to achieve inter-taxpayer equity in multinational banking, it is imperative that domestic and international banks, as well as bank and non-bank entities, are taxed similarly. Inter-taxpayer equity is not achieved where there is distortion through double taxation or less than single taxation.

It is not the purpose of this article to outline the tax regime applicable to multinational banks but, rather, to demonstrate their unique nature, which in turn supports the argument that they should be considered separately for the purposes of a tax regime. However, to demonstrate the taxation problems arising out of the unique nature of multinational banks it is necessary to outline the broad tax principles.

As stated earlier, the current tax regime applies both jurisdictional allocation rules and transactional allocation rules[17] based on a system originating in 1923. The current jurisdictional allocation rules considered are those of source, that is determining the source

[12] Plambeck, n 8 at 1134. As Plambeck points out: "There are few sources that specifically address the issues raised in transfer pricing analysis of global trading activities".

[13] OECD, *The Taxation of Global Trading of Financial Instruments* (OECD, 1998) p 7.

[14] Musgrave refers to this as interjurisdictional equity: Musgrave P, "Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union" in Cnossen, n 4, p 46.

[15] Vogel K, "Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part I)" (1988) 16 *Intertax* 216.

[16] For a discussion on what "efficiency" means see Vogel K, "Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part II)" (1988) 16 *Intertax* 310.

[17] The phrases "jurisdictional allocation" and "transactional allocation" are used by McDaniel in reference to the works of Surrey: McDaniel PR, "NAFTA and Formulary Apportionment: An Exploration of the Issues" in Alpert HH and van Raad K (eds), *Essays on International Taxation* (Kluwer, 1993) p 309.

of the income. The current transactional allocation rules considered are those of the transfer pricing regime requiring an arm's length standard for transactions that occur between different parts of the one entity.

A robust source regime is required in any tax regime.[18] However, the unique nature of multinational banks means that the traditional source regime does not meet this criteria as it fails to allocate income according to economic activity.[19] It is argued that the cause of the failure of the traditional source regime, when applied to multinational banks, is twofold. The first failure of the regime is that it requires the classification of the income of multinational banks, which is based on historic legal notions of source. The second failure of the regime is that the unique nature of multinational banking means that income may be allocated to a particular geographical location different from the location of the economic activity.

The first failure arises because the current source regime requires each transaction to be examined in the context of the various possible categories of source of income. In the case of multinational banks, transactions often will not fit neatly into one of the legal classifications as these rules are designed with a reference point in the past.[20] New and innovative financial instruments are being created at a rate far greater than the current tax regime can keep pace with.

The second cause of failure to allocate income based on economic activity is a result of the unique nature of multinational banks, which is discussed later in this article. The unique nature of the intermediation services offered by multinational banks means that these services may be undertaken in a geographical location different from that of the end product. Further exacerbating this problem is the fact that certain multinational entities, including multinational banks, no longer operate as distinct and separate parts of the one entity. Rather, they operate as integrated wholes, with the synergy gains explaining why this type of multinational entity has become so widespread. This article argues that it is this operation through integrated wholes that makes it difficult to apply the traditional source concept to the income of these multinational entities, as income cannot be associated with particular geographical locations.[21]

Also distorting the attribution of profits is the transactional allocation issues of transfer pricing. Profits of a jurisdiction may be distorted by a multinational entity by the separate but related parts of that entity transferring goods and services at differing prices.

The solution to transfer pricing devised by the OECD is arm's length pricing. Each part of the multinational entity is treated as a separate part of the economic entity (whether it is a branch or a subsidiary) and a price is substituted that would have been used in the transaction if it had been with an unrelated third party rather than a related party within the

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[18] Graetz, n 5 at 1426.

[19] Graetz, n 5 at 1417.

[20] Ruchelman SC, "US Tax Considerations in International Derivative Products" (1993) 47 Bul Int'l Fisc Doc 235.

[21] Noren DG, "Commentary: The US National Interest in International Tax Policy" (2001) 54 Tax L Rev 337 at 345.

same multinational entity. The OECD has, for many decades, provided its solution to the manipulation of transfer pricing but it has also recognised the increasing significance of this manipulation in recent years. As a response to increased cross-border transactions and multinational enterprise operations, the OECD revised its international transfer pricing guidelines (OECD Guidelines) in 1995.[22] The current guidelines represent a consensus among 25 OECD member countries on the approach to international transfer pricing issues.

The arm's length standard is based on what is referred to as the separate accounting or separate entity approach. The separate parts of an entity are defined by reference to national boundaries, or what is commonly referred to as the "water's edge".[23] Income and expenses are allocated to the relevant jurisdictions on a transactional basis, that is, specific transactions are considered as if they were between distinct entities, with each entity reporting separate taxable income.[24]

To apply the current transfer pricing rules a two-step process must be followed. The first step is one of conceptual comparability to determine what the hypothetical distinct and separate enterprise would look like. It is argued that, in undertaking this step, a fiction is created in the case of multinational banks because of their unique features. The highly integrated nature of the multinational bank is considered a primary factor in the increasing difficulty in separating the component parts.[25] The unique organisational structure adopted by multinational banks also contributes to the fiction, especially where the integrated trading model is adopted.[26] The very reason for the existence of multinational banks often means that there will not be any arm's length competitors.[27] Further, it is difficult to allocate activities to the different parts of the multinational bank because the relationships between related parties are different to those of non-related parties.[28]

The second step is one of transactional comparability to determine the actual profits attributable to the subsidiary or branch of the multinational bank. It is claimed that there are three interrelated fictions in applying this step. The unique organisational structure and the highly integrated nature of multinational banks mean that often there is no direct evidence of comparisons in an uncontrolled situation.[29] In addition, there is frequently an absence of

[22] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD, 1995). The revised guidelines, issued on 13 July 1995, replaced those contained in the OECD's 1979 report on transfer pricing.

[23] Eden L, *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America* (University of Toronto Press, 1998) p 35.

[24] Bird RM, "The Interjurisdictional Allocation of Income" (1986) 3 *Australian Tax Forum* 333 at 337.

[25] Ross SG, "International Taxation: A 20 Year View" (1992) 57 *Tax Notes* 945 at 947; McLure CE Jr and Weiner JM, "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income" in Cnossen, n 4, p 248; Musgrave, n 14, p 55; Musgrave PB, "Revisiting the Theory of International Income Taxation: Principle Paper: Sovereignty, Entitlement, and Cooperation in International Taxation" (2001) 26 Brook J Int'l L 1335 at 1345.

[26] OECD, n 13, p 39.

[27] Avi-Yonah RS, "The Structure of International Taxation: A Proposal for Simplification" (1996) 74 Tex L Rev 1301 at 1343.

[28] Lebowitz BE, "Transfer Pricing and the End of International Taxation" (1999) 19 Tax Notes Int'l 1201 at 1203.

[29] Lebowitz, n 28 at 1204; Plambeck, n 8 at 1135; Noren, n 21 at 347.

comparables because of the unique services provided by multinational banks.[30] Finally, the type of inter and intra entity dealings for multinational banks are highly specialised and regularly intangible.[31]

It can be seen that in applying these principles, there are certain suppositions underlying the traditional international rules governing jurisdiction and allocation. This article maintains that these suppositions are not accurate for multinational banks. The three problematic assumptions underlying the current international tax system are that: it is possible to ascertain a geographical source for income; it is possible to treat each part of a multinational entity as a separate unit and to allocate profits based on an arm's length notion; and the place of incorporation is a matter of fundamental significance.[32]

Reality is somewhat different. A multinational bank operates globally and in an integrated manner, which makes it difficult to separate the entity into component parts. The consequence is that "there is no single source of income and separate accounting for each unit of a multinational is impossible".[33] The location of the multinational bank head office is not relevant to the profit location as income is derived from global operations.[34] Any attempt to allocate income on these principles is "as Justice Brennan said in the *Container* case, like 'slicing a shadow'".[35]

Before a detailed examination of the unique nature of multinational banks is undertaken to demonstrate that the traditional rationale for taxing these banks in the same manner as traditional multinational entities is flawed, the role of the multinational bank is considered.

3. THE ROLE OF THE MULTINATIONAL BANK

The role of the multinational bank as an entity is vastly different to that of traditional multinational enterprises. It is not in the business of providing a traditional product or service but, rather, acts as an intermediary. In the context of global trading, there are three major parties to transactions: capital users, capital suppliers and the financial intermediaries.[36] Financial intermediaries, generally multinational banks, profit from intermediating between capital users and capital suppliers.[37] The unique nature of intermediary services (and to a lesser extent the resultant products, or the innovative financial instruments which are used to deliver these services) performed by multinational banks are designed to meet client global demand. In this context, because one role of the

[30] Lester EE, "International Transfer Pricing Rules: Unconventional Wisdom" (1995) 2 ILSA J Int'l & Comp L 283 at 298; Wickham and Kerester, n 1 at 406.

[31] Graetz, n 5 at 1420; Avi-Yonah RS, "International Taxation of Electronic Commerce" (1997) 52 Tax L Rev 507 at 546; Newton TS, "Transfer Pricing and Income Shifting in Integrated Economies" in Cnossen, n 4, pp 215-216.

[32] Avi-Yonah RS, "Slicing the Shadow: A Proposal for Updating US International Taxation" (1993) 58 *Tax Notes* 1511 at 1512.

[33] Avi-Yonah, n 32 at 1512.

[34] Avi-Yonah, n 32 at 1512.

[35] Avi-Yonah, n 32 at 1512.

[36] Plambeck, n 8 at 1131.

[37] Plambeck, n 8 at 1131.

multinational bank is that of intermediary, the product supplied by the bank is ancillary to the true nature of its business. The true nature of its business is the supply of services. The services provided through the intermediation between borrower and lender enables borrowers and investors to reconcile their different objectives.[38]

By acting as an intermediary, a multinational bank is in the unique position of being able to separate its services role from the legal contracts that give rise to profit. It can provide advice to clients in one jurisdiction, with those clients completing the transaction (depositing or borrowing money) in another jurisdiction. Thus, profits are shifted away from the economic activity to the location of the supply of the ancillary product.

A multinational bank has several sources of income, some of which stem from the intermediation service provided. The sources of income range from the interest and dividends received with respect to the securities it is required to maintain to be a market-maker, to trading gains from sales of those securities.[39] It also earns income from: notional principal contracts, and other over-the-counter derivatives entered into with clients; fee income from structuring transactions; gains from dealing in liabilities; income from stock lending and repo transactions; and broker's fees from exchange transactions executed for clients.[40] Multinational banks also play an important role in the maintenance of efficiency in the financial markets, not only by operating as intermediaries between borrowers and lenders but also by managing the risk from a portfolio of transactions.[41]

The process of global trading consists of a number of roles, which are undertaken by multinational banks to earn this income. These roles can be categorised into trading, sales and marketing, management, and supporting functions.[42] Novel tax issues also arise because these functions may be conducted across a number of jurisdictions.[43]

The difference in the role of the multinational bank stems from the unique features associated with it. Each of the unique features is examined in turn.

4. THE UNIQUE NATURE OF THE SERVICES AND CONSEQUENT PRODUCTS

The first difference between a traditional multinational entity and a multinational bank is the services and consequent products supplied. The nature of the services and resultant products

[38] Neighbour J, "Innovative Financial Instruments Challenge the Global Tax System" (1997) 14 Tax Notes Int'l 931 at 931.

[39] For a general description of the types of income earned by multinational banks, see Reich YZ, "US Federal Income Taxation of US Branches of Foreign Banks" (1994) 2 Fla Tax Rev 1.

[40] OECD, n 13, p 12(para 7).

[41] OECD, n 13, p 11(para 3).

[42] OECD, n 13, p 13(para 14).

[43] The OECD documents recognise that there are unique tax issues associated with global trading. It states that the tax issues "involve questions as basic as when do trading activities conducted in other countries, either directly or through affiliates acting as agents, constitute a permanent establishment, how to determine the income attributable to those permanent establishments, how to apply traditional transfer pricing methodologies to transactions between associated enterprises involved in an integrated business, and basic timing issues": OECD, n 13, p 13(para 15).

provided by multinational banks is a response to clients' needs in relation to which the banks undertake the intermediary role in the marketplace.

This unique feature is examined in three interrelated subcategories. The first subcategory looks at globalisation and the increase in global trading in the context of multinational banking in order to explain the functions of a multinational bank. This establishes the differences between the functions of the traditional multinational entity and the multinational bank, together with the differences between the multinational bank and purely domestic banks. The second subcategory considers the growth and evolution of the multinational bank, providing explanations for the rise of these entities. This part of the article considers the compulsion by banks to follow clients to international jurisdictions, along with the internalisation theory of undertaking multinational activities. The third subcategory examines the monopolistic nature of multinational banking, with the personal contact advantage providing synthesis of information. This is considered in order to establish further unique source and transfer pricing issues that arise with multinational banks.

4.1 Globalisation and the increase in global trading

To demonstrate the unique nature of multinational banking, it is necessary to define a multinational bank and consider the functions undertaken in the world market. This world market is continually changing with business becoming increasingly global, and borders becoming progressively meaningless to those partaking in the provision of services and products internationally.[44] Different terminology has been used to describe these activities and, as such, it is necessary to consider what "multinational banking" means.

Trading in the international arena does not alone determine an entity to be multinational. A multinational entity deals internationally in a particular way, in that it is a business venture which "owns and controls income-generating assets in more than one country"[45] or "an enterprise that owns and controls activities in different countries".[46] A multinational entity has been more comprehensively defined as:

> [a] business created and owned by a group of private investors which is engaged in carrying out business and commercial activities in two or more states. A multinational corporation usually owns assets and conducts foreign trade and investment over a number of geographically, politically, and economically diverse countries.[47]

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[44] Avi-Yonah, n 31 at 527; Avi-Yonah RS, "Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113 Harv L Rev 1573 at 1649.

[45] Fieldhouse DK, "The Multi-national: A Critique of a Concept" in Teichova A, Levy-Leboyer M and Nussbaum H (eds), *Multi-national Enterprise in Historical Perspective* (Cambridge University Press, 1986) p 9, quoting from Dunning JH (ed), *Economic Analysis and the Multi-national Enterprise* (Allen & Unwin, 1974) p 13.

[46] Buckley PJ and Casson M, *The Future of the Multi-national Enterprise* (2nd ed, Macmillan, 1991) p 33.

[47] Nygh PE and Butt PJ (eds), *Butterworths Australian Legal Dictionary* (Butterworths, 1997) p 767.

It is not necessary, therefore, for an entity to be established in two or more jurisdictions to be involved in international trade, but this is necessary if that entity is to be classified as multinational.

An entity dealing in the international market, but not established in two or more jurisdictions, is not a multinational entity. Domestic entities may successfully trade in the international market other than as a multinational entity. For example, business conducted through an offshore agent or via a joint venture is not consistent with the definition of a multinational entity. Similarly, a firm that trades on the international market via an internet site is not within the definition of a multinational entity. Conversely, once an entity is established in two or more jurisdictions it is classified as multinational.[48]

It follows that a multinational bank is a multinational entity operating banking facilities. A multinational bank has been defined in very simple terms as "a bank that owns and controls banking activities in two or more countries".[49] Like all entities engaging in international business it must be determined whether the bank in question is truly multinational or merely international. A more concise definition of a multinational bank is one which encompasses foreign direct investment by the bank, as a parallel to the requirement that a multinational entity be established in two or more jurisdictions.

Multinational banks may also be considered in the context of globalisation to determine the functions performed. Globalisation and internationalisation are words that have recently become part of everyday language, and are usually used in the context of anything involving more than one jurisdiction. Globalisation, however, is more precise than this, as it involves the process by which the world becomes a single marketplace,[50] and is a product of entities undertaking internationalisation, that is, dealing in the international market.[51] Globalisation is one of the challenges facing tax authorities today and is a factor driving future tax policy,[52] with the effects of globalisation having profound implications for tax systems.[53]

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[48] A business enterprise that is considered multinational is commonly referred to as either a multinational entity (MNE) or a multinational corporation (MNC). These two terms are generally interchangeable with their use depending on authorship. For example, the United Nations, in its Code of Conduct (the *United Nations Conference on Trade and Development Code of Conduct for Multinational Corporations*), refers to MNCs, while the OECD, in its Guidelines (the *Organisation for Economic Cooperation and Development Guidelines for Multi-national Enterprises*) refers to MNEs.

[49] Casson M, "Evolution of Multi-national Banks: A Theoretical Perspective" in Jones G (ed), *Banks as Multi-nationals* (Routledge, 1990) p 14.

[50] Nygh and Butt, n 47, p 525.

[51] Although in an international taxation setting Bird and Wilkie suggest that "'globalization' is little more than an imprecise code word for the fact that national tax authorities everywhere are in trouble owing to the increasing irrelevance of national borders with respect to determining the location of economic activity in traditional tax policy terms": Bird and Wilkie, n 4, p 80.

[52] The general view is that globalisation of national economies raises compelling questions as to the continued viability of the existing international tax regime: Zonana V, "Introduction: International Tax Policy in the New Millennium: Developing an Agenda" (2001) 26 Brook J Int'l L 1253. Although there is a suggestion that political will could be the determinative factor in driving international tax policy: Ross SG, "Commentary: Political and Social Aspects if International Tax Policy in the New Millennium" (2001) 26 Brook J Int'l L 1303 at 1304.

[53] Zonana, n 52 at 1254; Minz JM, "National Tax Policy and Global Competition" (2001) 26 Brook J Int'l L 1285.

Globalisation has been described as the 20th century's greatest economic event,[54] yet it is a process that has existed for hundreds of years; it is only the extent and pace of change which is new.[55]

A multinational bank contributes to the globalisation of the financial market, and most engage in global trading. The OECD documents, in the context of the taxation of financial instruments, describe global trading as "[t]he catch-all phrase that focuses on the capacity of these financial institutions to execute customers orders in financial products in markets around the world and/or around the clock".[56] Plambeck similarly describes global trading as "the capacity of financial intermediaries to make markets and to take proprietary positions in financial markets around the world and around the clock".[57] Global trading may be complex, where "typically, a global trading business, through its various offices, will work on a given transaction or project, in varying and unpredictable degrees, developing, monitoring, negotiating, and concluding transactions on an ongoing 24-hour basis worldwide".[58]

As global trading is a by-product of the motivational factors behind entering a foreign market, most multinational banks undertake at least a proportion of global trading. Global trading raises tax questions such as whether cross-border trading conducted in a foreign country constitutes a permanent establishment, how to determine income attributable to an existing permanent establishment and how to apply transfer pricing methods.[59]

The increase in global trading is driven by the global demand created by the clients of banks, both borrowers and investors. In particular, the global market established by traditional multinational entities created a demand for the innovative financial instruments subsequently developed by multinational banks.[60] An explosive growth of these innovative financial instruments has occurred over the last 25 years.[61] More recently, sophisticated derivative instruments have been created by multinational banks to allow multinational entities to manage risk themselves.[62] Technological development has accelerated this process of financial globalisation.[63] By responding to the demand created, multinational banks have facilitated the efficient operation of the financial markets.

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[54] Melo GM, "Taxation in the Global Arena: Preventing the Erosion of National Tax Bases or Impinging on Territorial Sovereignty?" (2000) 12 Pace Int'l L Rev 183 at 193.

[55] Easson AJ, *Taxation of Foreign Direct Investment* (Kluwer Law International, 1999) p 156.

[56] OECD, n 13, p 12(para 9).

[57] Plambeck, n 8 at 1131.

[58] Shea GC, "Transfer Pricing: APAs may Effectively Address Income and Expense Allocation Problems Faced by Global Trading Businesses" (1992) 4 Tax Notes Int'l 1022 at 1022.

[59] Yamanouchi A, "International Tax Issues Affecting Electronic Commerce and Banking" (1997) 14 Tax Notes Int'l 1619 at 1621.

[60] Neighbour, n 38 at 931.

[61] Colon JM, "Financial Products and Source Based Taxation: US International Tax Policy at the Crossroads" [1999] U Ill L Rev 775 at 777.

[62] OECD, n 13, p 11(para 3).

[63] Prowse S, "Alternative Models of Financial System Development" in Edey M (ed) *The Future of the Financial System* (Reserve Bank of Australia, 1996) p 125.

Contributing to this growth in global trading was the broadening and deepening of the customer base which occurred in the late 1980s, concurrent with an awareness among tax administrators of the unique tax issues relating to the function of global trading undertaken by the financial institutions. While technological, economic and regulatory developments contributed to the expansion of global financial trading,[64] such expansion would not have occurred without the increased international trade of traditional multinational entities. This concept of the multinational banks arising out of the needs of traditional multinational entities is explored further later in this article.

The rising role of global trading undertaken by multinational banks, which consists of a number of functions, can generally be categorised into trading, sales and marketing, management, and supporting functions.[65] The commonality among these service roles is that they may be conducted across a number of jurisdictions simultaneously. It is this feature which further distinguishes the services provided by multinational banks from those of other multinational entities, which are normally restricted by geographical boundaries. New technologies expedite tremendously the cross-border capabilities of these financial service organisations as compared with manufacturers.[66]

The consequence of this lack of geographical restriction, because of the types of services being offered, is that the tax position of multinational banks may not correspond with economic reality.[67] The growth in financial instruments, and the consequential global trading, has outpaced the evolution of tax rules, which means that such situations are not adequately dealt with.[68]

Manipulation by a multinational bank may result in less than single taxation but, more fundamentally, it may result in an outcome that fails to accord with economic reality. It is the proposition of this article that this taxation irregularity is exacerbated for multinational banks because of the nature of their services and consequent products. Adding to this irregularity is the fact that the service role may be conducted across multiple jurisdictions simultaneously. By acting as intermediaries, multinational banks operate seamlessly across borders, through a web of subsidiaries, branches and representative offices. This allows for distortion both through the application of the current source regime as well as the arm's length requirement of the transfer-pricing regime.

[64] Samuels LB and Brown P, "Observations on the Taxation of Global Securities Trading" (1990) 45 Tax L Rev 527 at 529-530.

[65] OECD, n 13, p 13(para 14).

[66] Guttentag JH, "Key Issues and Options in International Taxation: Taxation in an Interdependent World" (2001) 55 Bul Int'l Fisc Doc 546 at 547.

[67] Tanzi suggests that in some cases of enterprises becoming multinational they have almost lost their original national identity, especially in an economic sense: Tanzi V, "The Impact of Economic Globalization on Taxation" (1998) 52 Bul Int'l Fisc Doc 338 at 339.

[68] Samuels and Brown, n 64 at 527.

The principal tax consequence of the intermediary services provided by multinational banks is the ability of the banks to perform these services for clients anywhere in the world while providing the product in a low-tax jurisdiction. An application of the current source rules may then result in the jurisdiction where the services are performed failing to receive any tax revenue. The OECD 1998 discussion draft suggests that there are further tax consequences.[69] It suggests that there are four aspects of multinational bank dealings that increase the likelihood of a distortion of the taxation position from the aim of the traditional regime. The first aspect is the fact that, inherent in the nature of global trading, there is a necessity to delegate some marketing or trading authority to affiliates. The question then raised is whether the affiliate is acting as a dependent agent for the purposes of determining whether a permanent establishment exists. The second aspect relates to the difficulties that arise in allocating profits among the jurisdictions because of the integrated nature of global trading. The third aspect is the mobile nature of capital, a commodity heavily relied upon by multinational banks, which allows expected profits or losses to be transferred between jurisdictions. The fourth aspect is the lack of accounting and regulatory standards.[70]

4.2 The growth and evolution of multinational banks

The relatively late arrival of most multinational banks into the international arena, their distinguishing features from other multinational entities and the unique nature of taxation consequences for multinational banks are best illustrated in light of a consideration of the history of multinational banking in a global context. This section addresses the evolution of multinational banks, as a subset of multinational entities, within the framework of both the demand driven by multinational clients and internalisation theory.

Before embarking on an examination of the history of multinational banking, it is necessary to acknowledge the lack of common terminology, and the hampering effect this has had on any substantive research into the economic consequences and taxation issues relating to multinational entities in general and multinational banks specifically. Prior to the study of the multinational entity per se, an entity involved in such activities was examined in the context of foreign direct investment or the business corporation.[71] It was not until nearly two centuries after the beginning of the multinational entity that the first term used to describe the phenomenon, the "multinational corporation", was coined.[72] In 1960, Lilienthal described multinational corporations as "corporations which have their home in one country but operate and live under the laws and customs of other countries as well".[73]

The consequence of the lack of a defined term describing such behaviour was that regulation and tax policy, until relatively recently, was considered within the framework of international investment as a whole, rather than being split into the necessary subcategories,

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[69] OECD, n 13.

[70] OECD, n 13, p 28(para 105-106).

[71] Fieldhouse, n 45, p 11.

[72] Fieldhouse, n 45, p 9.

[73] Aharoni Y, "On the Definition of a Multi-national Corporation" (1971) 11 Q Rev Econ Bus 27 at 27.

foreign direct investment being one. It has been demonstrated that a multinational entity deals internationally in a particular way, that is, the entity owns and controls income-generating assets in more than one country. Any research into international trade, however, was done in a much broader context.

The first significant modern analysis of the special features of investment by a multinational entity has been attributed to Australia.[74] Economists in Australia were alerted to the unique nature of the multinational entity and its investment and profit distribution strategies through the sudden expansion of General Motors Holden in the 1950s. The impetus for investigation into the economic effects was the transfer of US$4.5 million, out of a reported 1953 profit of US$9.8 million, to the United States as a dividend.[75] Although the modern multinational entity had been in existence prior to this, both in Australia and other jurisdictions, this study was the first to consider the effects of foreign direct investment, concluding that such effects are unique.

Because of the lack of terminology and academic literature, it is generally assumed that the multinational entity is a post-war phenomenon. This type of structure, however, is a feature of modern commerce as old as modern mercantilism. Though there is no doubt that the growth of the multinational entity in the post-war period has been remarkable,[76] the beginnings of the multinational entity can be traced back to foreign direct investment in Europe centuries before.[77] Traditionally, the manufacturing market was the leader of multinational firms, initially facilitated through the inventions of the steamship, railway and telegraph.[78] Over time, this geographical diversification of the firm, initiated at a domestic level, has refined itself and transformed into the multinational entity.

Similarly, multinational banking has a long history, with evidence of international banking (as contrasted with multinational banking) in Babylonia as early as 465 BC.[79] Despite the steady rise of a geographically diversified banking services market, as recently as three decades ago banks were excluded from discussions of multinational entities. For example, Aharoni in his 1971 article suggests that the definition of the multinational entity can be subdivided by three criteria: the types of operations in which they are involved; the size of their operations; and the areas in which they operate.[80] Corporations, according to the types of operations in which they are involved, are divided into exporters, importers,

[74] Fieldhouse, n 45, p 11.

[75] Fieldhouse, n 45, p 11.

[76] Buckley and Casson, n 46, p 1.

[77] As early as the 1780s, trade companies involved in the cotton industry were carrying on the functions of what is now considered to be functions of multinational entities.

[78] Milgrom P and Roberts J, *Economics Organisation and Management* (Prentice-Hall, 1992).

[79] Burgers IJJ, *Taxation and Supervision of Branches of International Banks: A Comparative Study of Banks and Other Enterprises* (IBFD Publications, 1991) p 27.

[80] Aharoni, n 73 at 35.

transporters, manufacturers, traders and petroleum producers. The obvious omission from this list is the service provider, in which category the multinational bank would fall. Multinational entities were thought to be providers of goods rather than services; an assumption, it could be argued, that legislators have also made.

Over the course of the last three decades it has been acknowledged that banking has become a multinational service. The issue then is to why banks have become multinational. To address this, two theories have been devised. The first, a demand-driven argument, is that one consequence of the modern multinational entity is the need for more geographically diversified financial arrangements and products, hence the services market, including banking, gradually entered the multinational arena.[81] Casson believes that "[t]he growth of foreign direct investment in manufacturing by high-technology mass-market-oriented firms created a new demand for corporate banking services overseas".[82] In essence, "the multi-nationalisation of manufacturing firms creates a derived demand for the multi-nationalisation of banks as well".[83]

The emergence of the multinational bank, therefore, has followed the emergence of the traditional manufacturing multinational entity, with growth in recent decades. Banks have become multinational not because of the income opportunities presented by foreign jurisdictions but, rather, for fear of losing their domestic clientele if they failed to follow those clients overseas.[84] This theory on the global expansion of banks has been termed the "defensive expansion approach", that is, banks are being reactive rather than proactive in ensuring their client base does not diminish.[85]

A counter argument to the defensive expansion approach is that banks followed their customers overseas not for fear of losing their domestic base, but because of the knowledge advantage they possess. This knowledge advantage is borne of the client-bank relationship, and becomes a public good within the firm which can be best exploited by expanding offshore. This argument is founded in the theory of internalisation.[86] As enunciated by Plummer:

> Internalisation is about imperfections in intermediate product markets. Intermediate products flow between activities within the production sector. Market imperfections generate transaction costs and these costs are often minimised for the sector as a whole by bringing interdependent activities under common ownership and control.[87]

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[81] Williams states "[t]hat banks follow their clients abroad is the most pervasive proposition in multinational banking": Williams B, "The Defensive Expansion Approach to Multinational Banking: Evidence to Date" (2002) 11 *Financial Markets, Institutions and Instruments* 127 at 127.

[82] Casson M, *The Organisation of International Business* (Edward Elgar Publishing, 1995) p 161.

[83] Casson, n 82, p 162.

[84] Ferguson RA, "Foreign Banks in Australia – A Strategic Reassessment" (1990) 9 *Economic Papers* 1 at 7.

[85] For a comprehensive literature review on the defensive expansion theory see Williams, n 81.

[86] Internalisation theory draws upon the Coasian theory of the firm: Coase AH, "The Nature of the Firm" (1937) 4 *Economica* 386.

[87] Casson, n 82, p 22.

Implicit in the internalisation theory are the assumptions that: the primary goal of any capitalist entity is to maximise profit, and as part of achieving that goal, minimise expense; and there is an imperfect market.[88] Internalisation theory explains why multinational banks exploit their ownership advantages within their own system rather than contracting them in a regular market where there are imperfections.[89]

Clearly, banks are profit-driven entities and are internalising a market failure, information asymmetry.[90] That is, due to the existence of information asymmetry, the expense of international banking transactions is minimised if conducted by multinational banks rather than by independent entities. The decrease in expense is due to the intangible nature of the asset; in particular, the fact that it is difficult to efficiently transfer the information and, further, the fact that it is difficult to accurately price the value of the information. This information cost-saving is the motivation for domestic banks expanding into multinational banks. It is important to note that information asymmetry would not be a valuable asset were it not for the global expansion of the banks' clientele. This internalisation hypothesis encompasses most of the extant theories as to the multinational expansion of banks.

This theory, while not explicitly adopted, seems to be inherent in the tax literature. For example, Colon explains that the driving force behind the "continuing creation of new financial instruments is the demand for cost effective mechanisms by which firms can manage their financial price risks – the risks firms face due to unexpected movements in foreign exchange rates, interest rates, and commodity prices".[91] What is very much accepted in the tax literature is that there are the economic advantages to becoming multinational.[92]

Whether driven by a compulsion to follow clients or driven by internalisation theory, it is clear that multinational banks are a product of the globalisation of business and the establishment of traditional multinational entities. Although it is often stated that technological development, financial innovation and the political economy have all contributed to the global trading of multinational banks,[93] all of these factors are associated with demand, driven by traditional multinational entities. Technological advances allow the clients of multinational banks to participate in international transactions, while the

[88] Casson, n 82, p 22.

[89] Cho KR, "Determinants of Multi-national Banks" (1986) 26 MIR 10 at 13.

[90] Williams B, "Positive Theories of Multinational Banking: Eclectic Theory versus Internalisation Theory" (1997) 11 J Econ Surv 71.

[91] Colon, n 61 at 777.

[92] See, eg Lebowitz, n 28 at 1202; Li J, "Global Profit Split: An Evolutionary Approach to International Income Allocation" (2002) 50 Can TJ 823; Bird RM and Brean DJS, "The Interjurisdictional Allocation of Income and the Unitary Taxation Debate" (1986) 34 Can TJ 1337 at 1382; Lester, n 30 at 295; Peroni RJ, "Back to the Future: A Path to Progressive Reform of the US International Income Tax Rules" (1997) 51 U Miami L Rev 975, fn 77; Langbein SI, "Transaction Cost, Production Cost, and Transfer Pricing" (1989) 44 *Tax Notes* 1391 at 1392.

[93] Plambeck, n 2 at 529.

innovative financial products allow for greater protection against risk. The political economy, by no longer restricting the transfer of capital, has also allowed interested parties to become involved. The increasing number of international dealings and transactions, both related and unrelated, has created a market demand for multinational banks and the services that they provide. The multinational bank, therefore, is not a traditional multinational entity but rather a product of the traditional multinational entity.

Being a product of the traditional multinational entity, it is suggested that it is difficult to apply tax rules designed for that traditional multinational entity to a relatively new phenomenon. While critics of the current transfer pricing regime have always argued that it fails to take into account the synergistic advantages of the multinational entity, due to the highly integrated nature of the services provided by multinational banks as well as the intangible nature of the assets being dealt in, the problems of ignoring such synergistic advantages are exacerbated. Rather than expanding internationally to meet the needs of a new market, multinational banks are expanding internationally to meet the needs of existing clients. Synergies, therefore, are taken to the extreme. This difficulty is then compounded by the unique nature of the intermediary services being offered.

4.3 Monopolistic advantages and network linkages

There are two further, interwoven distinguishing characteristics in relation to the services of the multinational bank; the monopolistic advantages and the network linkages. First, the monopolistic nature of multinational banking, with the personal contact advantage providing synthesis of information, is a basis for distinguishing the commerce of multinational banks from those of traditional multinational entities. This information is the basis of the service that the multinational bank is providing and is a bank-specific asset.

A manufacturer has product and/or technology advantages with the potential to transfer that knowledge to foreign jurisdictions. A bank, on the other hand, has the personal contact advantage. This leads to the creation of a network of information with team-specific skills being developed to synthesise bank information.[94] Such monopolistic advantages add to the source and transfer pricing problems because of the unique nature of multinational banks. These problems are founded primarily in the integrated and exclusive nature of the information possessed by the multinational banks. Essentially, the integrated nature of the information network means that it is difficult to apply any traditional legal source rule to obtain a result reflecting economic reality. Using a traditional arm's length methodology to price any related party transactions is also unachievable as, due to the exclusive nature of the transferred services, there are no comparable unrelated transactions.

Related to the monopolistic advantages of multinational banks are the highly sophisticated network linkages within multinational banks. When considering the network structure of multinational banks in comparison with vertically integrated multinational entities, there are two special features. The first special feature is the flow between the

[94] Casson, n 82, p 156.

facilities that is two-way, unlike manufacturing multinational entities where the process is more likely to be unidirectional. The second special feature is that there are several different locations involved in the network, creating a complex set of linkages.[95] Such a network is less likely to be achieved by a manufacturing multinational entity because of the physical nature of the product.

These distinguishing features add to the problems created by the multinational banks' compulsion to follow clients. Not only are there synergies with respect to the client base and information, but there is also the personal contact advantage providing a synthesis of information. Essentially this leads to a highly integrated multinational entity that is effectively impossible to separate into its components. The difficulties in attempting to do so suggest that it is a fiction to determine the hypothesised independent entity for the application of the transfer pricing regime, particularly to permanent establishments.

The services and consequent products of multinational banks are distinct from those of traditional multinational entities, primarily due to their intermediary nature. Three further distinguishing features underlie and compound the taxation problems associated with this intermediary nature. First, the ability of services of the multinational banks to be implemented simultaneously across multiple jurisdictions is in stark contrast to the unitary nature of multinational entity transactions. Secondly, multinational bank services are often a result of the demand of traditional multinational entities and, finally, the personal contact advantage held by multinational banks is fundamentally different to the product and technological advantages held by traditional multinational entities.

It is the contention of this article that, in addition to the service and product differences, organisational differences between traditional multinational entities and multinational banks render the rules governing jurisdiction to tax and allocation of income in the current tax regime unsuitable for multinational banks.

5 THE UNIQUE ORGANISATIONAL STRUCTURE

Due to the role of multinational banks in servicing traditional multinational entities, the organisational structure of the multinational bank, designed to meet client demand, diverges from that of the traditional multinational entity. While the current tax model is designed for traditional multinational entities, the different structure of multinational banks introduces issues previously not recognised by the traditional taxation system. It is the unique organisational structure of the multinational bank that this part of the article examines.

The growth of multinational entities, and consequently multinational banks, establishes that financial markets are becoming increasingly globalised and integrated.[96] The development of the multinational bank also requires a consideration of why these entities

[95] Casson, n 82, p 157.

[96] Demirguc-Kunt A and Huizinga H, "The Taxation of Domestic and Foreign Banking" (2001) 79 J Public Econ 429 at 429.

choose to become involved in the international market through foreign direct investment rather than merely exporting their services from the parent jurisdiction or by operating through an agent. By doing so, it is possible to consider whether banks are unique not only because of their unique service qualities but also because of their organisational structure.

5.1 Entering the market through foreign direct investment

A bank wishing to enter a foreign market may do so in a number of ways. The bank has three choices. The first choice is to enter the market by exporting the services from the parent jurisdiction to the foreign jurisdiction. This involves little in the way of physical or capital presence in the foreign jurisdiction. The second choice is to enter a foreign market by operating through a local agent, usually a bank already existing within the foreign jurisdiction. The third choice is to enter a foreign market through foreign direct investment. Where the third option is undertaken, the multinational bank accesses the market using one of three trading structures: foreign subsidiary, foreign branch or foreign representative office. Regardless of the specific organisational form, however, foreign direct investment implies the transfer of capital, managerial expertise and the technological assets of a bank from one country to another.[97]

Although not unique to the enterprise of banking, the third option of foreign direct investment[98] is the preferred method of foreign market entrance adopted by banks. As such, it is important to consider this specific geographical expansion strategy to determine the associated unique taxation consequences. This choice of investment strategy is referred to as foreign direct investment because "the defining mark of a multinational is that it makes and manages direct investments in foreign countries".[99] Thus, foreign direct investment may be achieved without a physical presence in the foreign jurisdiction; however, capital investment is necessary.[100] For example, a bank can invest offshore by buying shares or bonds. Clearly, this can be distinguished from a manufacturing entity, where investment in its line of business requires a physical presence. Foreign direct investment, in the economic sense, involves any investment by an entity which it has ultimate control over.

Direct investment has been more comprehensively defined as an activity which consists of four dimensions: a transfer of capital, a control investment, a source of funds for foreign operations and a balance of payments flow.[101] According to Eng, Francis and Mauer:

> direct foreign investment involves transferring capital from a source or home country to a host country. In comparison with other forms of international investment, the

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[97] Cho, n 89 at 11.

[98] For a general discussion on foreign direct investment see Graham EM and Krugman PR, *Foreign Direct Investment in the United States* (3rd ed, Institute for International Economics, 1995).

[99] Chandler AD, "Technological and Organizational Underpinnings of Modern Industrial Multi-national Enterprise: The Dynamics of Competitive Advantage" in Teichova et al , n 45, p 30.

[100] A threshold figure of 10% is taken to distinguish portfolio investment from direct investment: Easson, n 55, p 2.

[101] Eng MV, Francis AL and Mauer LJ, *Global Finance* (2nd ed, Addison-Wesley, 1998) p 403.

distinguishing feature for FDI [foreign direct investment] is the element of control over management policy and decisions.[102]

The two prerequisites for foreign direct investment, therefore, are a transfer of capital and control. Economists provide an insight into the reasons for pursuing such investment strategies.

Fieldhouse, quoting from Plummer,[103] suggests that there are three main reasons for the establishment of what he refers to as international combines or trusts (or what are contemporarily called multinational entities):[104]

> the need to keep plants fully employed; desire to escape from severe competition, price cutting and so on; and … the desire to substitute certainty for the uncertainties of business as previously conducted.[105]

Plummer's reasons are a precursor to "internalisation" and, as discussed previously, according to this theory multinational banks are internalising the market failure of information asymmetry. Internalisation explains how the multinational entity achieves the goal of cost reduction.

Costs associated with the external market, which can be avoided through the establishment of a multinational entity, include: brokerage costs; costs of defining the obligations of the contracting parties; the risk of scheduling and the related input costs; and the taxes paid on the transactions.[106] In the case of multinational banks, the costs which are commonly avoided by becoming multinational are the costs associated with intangible assets; in particular, the cost of effectively transferring information and the cost of accurately determining the sales value of the information.[107]

Such benefits have been recognised in tax literature when considering an economically valid basis for establishing jurisdictional allocation of income. For example, Bird provides:

> in the absence of such "intangible assets" that can be exploited by multinational enterprises, it would be hard to understand their existence at all, let alone their dominance in important fields, since foreigners are inherently at a disadvantage compared to local firms unless they have some offsetting internal advantages as a result of being under common control.[108]

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[102] Eng et al, n 101.

[103] Plummer A, *International Combines in Modern History* (Pitman, 1934).

[104] Plummer states that we have an "international trust" when, to centralised and unified control, there is added the complete merger and ownership of the constituent undertakings, in two or more countries: see Fieldhouse, n 45, p 13.

[105] Fieldhouse, n 45, p 14.

[106] Williams, n 90 at 74.

[107] Williams, n 90 at 74.

[108] Bird, n 24 at 334.

Cho, in addressing the issue of why banks choose to operate in foreign jurisdictions through foreign direct investment, suggests that three questions should be answered simultaneously: what advantages does a bank have which allow it to compete against local and/or other foreign banks; why is a foreign rather than a domestic operation advantageous in serving foreign and/or domestic markets; and why does a bank choose to exploit these advantages itself rather than selling them to local and/or other foreign banks?[109]

In answering these questions, it must be remembered that there is the general view that multinational banks arose from the demand produced by the increase in foreign direct investment in manufacturing by high-technology mass-market-oriented firms. Economic theory regards this as the defensive expansion approach, which some economists regard as a specific application of internalisation theory rather than a separate theory as outlined above.[110] In explaining defensive expansion in the context of internalisation theory, Williams points out:

> The growth in multinational banking is due to foreign direct investment abroad by corporations. Banks respond to the expansion of their clients abroad to defend their client-bank relationship. If the banks do not accompany their client abroad, the client will establish a banking relationship that could expand to supplant any domestic banking relationships. A banking relationship consists of a flow of information. This flow of information enables the bank to assess any new loan proposal at low marginal cost, as most of the assessment has occurred previously. This lower marginal cost gives a bank's offshore subsidiary a competitive advantage over its incumbent competitors. Due to market failure, this information flow cannot be traded or priced within the market and so must be exploited by owning banks.[111]

This theory is consistent with evidence of expansion into certain jurisdictions. For example, it has been suggested that most banks came to Australia "as part of a reluctant world wide globalisation that was based on a defensive mentality rather than an aggressive strategy".[112]

If the economists' view is accepted that banks capitalise on these market imperfections (namely, the restraints on trading and pricing customer information) purely to defend their client-bank relationships, then their adoption of the foreign direct investment method is rational. Not only does the foreign direct investment approach give the banks a global presence, it also gives them *control* over that presence. When compared to the alternative organisational structures of exporting their services or operating through an agent, it is this higher level of control associated with foreign direct investment that enables the banks to effectively "defend" their client-bank relationships as required. Expanding, therefore, on

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[109] Cho, n 89 at 11.

[110] Williams, n 90 at 76.

[111] Williams, n 90 at 86.

[112] Ferguson, n 84 at 7.

what is already accepted in relation to economic theory explaining multinational banking as discussed earlier, this article accepts the defensive expansion approach, as a subset of the internalisation theory, as the basis for the adoption of foreign direct investment by multinational banks.

In this context, foreign direct investment is broadly defined to include the three alternative trading structures adopted by multinational banks: foreign subsidiaries, foreign branches and foreign representative offices. A subsidiary operates as an independent legal entity as distinct from the foreign bank, being separately chartered under the laws of the local country.[113] Subsidiaries are generally wholly-owned, or at least controlled, by the foreign parent bank.[114] In contrast, a branch is an integral part of the foreign bank without a separate legal personality.[115] Of even less independence is a representative office which is “a small office in the host nation that coordinates a bank’s correspondent banking relationships and renders assistance to the bank’s existing customers”.[116] While the level of independence of each of these three structures differs, they are all vertically integrated organisation models. This is contrasted with the generally horizontally integrated nature of the traditional multinational entity.

Entering a foreign market through foreign direct investment does not make a multinational bank unique. What does make it unique is the lack of a large physical presence required in a jurisdiction. It is very simple for a bank to establish a subsidiary or branch (permanent establishment) in a given jurisdiction and to undertake transactions through that office. While very little in the way of intermediary activity may be undertaken in that location, in fact, a large percentage of the source of income under the current legal source rules may be attributable to that office and hence that jurisdiction. There are also unique tax issues that arise because of the transfer of capital to a potentially low tax jurisdiction in order to take advantage of the source rules. The transfer of capital of itself raises transfer pricing issues, with the arm’s length requirement for pricing such a transfer often failing to replicate economic reality. The external market costs mentioned above are ignored for these purposes and, as such, the result is not an optimal one.

5.2 Alternate trading models and the highly integrated nature of the multinational bank

[113] Davis K and Lewis M, “Foreign Banks and the Financial System” in *Australian Financial System Inquiry* (AGPS, 1982) p 591.

[114] Williams B, “Multinational Banking and Global Capital Markets” in *Encyclopaedia of Life Support Systems* (Eolss Publishers, 2002) p 7, see http://www.eolss.net viewed 28 October 2008.

[115] Davis and Lewis, n 113.

[116] Williams, n 114, p 4.

To evaluate the current jurisdiction to tax and allocation of income principles, it is necessary to consider whether the structure and behaviour of the multinational bank mirrors that of the traditional manufacturing multinational entity. While the governing economic principles behind the structure and behaviour are the same, the way that these principles operate in practice may be different.[117] The reason for this is the way in which the entity establishes its operations. Manufacturing multinational entities are traditionally, and more commonly, horizontally integrated, while multinational banks tend to be vertically integrated.[118] A horizontally integrated multinational entity provides the same goods and/or services from several different locations, while the vertically integrated multinational entity has one location producing output, which becomes input at the next location.[119] This type of integration leads to novel transfer pricing issues.[120] Where the multinational entity is vertically integrated, it is difficult to find comparables, as often they simply do not exist.[121] The reason these comparables do not exist is that they have been driven out of the marketplace. Lebowitz explains:

> For example, if a parent-subsidiary relationship turns out generally to be more profitable in an industry than contractual arrangements between unrelated parties, one can expect that vertical integration will become the dominant, and ultimately the only, mode of economic organization in the industry because competition will render independent party relationships economically unviable. When that occurs, as it often has, for example, in relationships between manufacturers and distributors, the arm's-length standard becomes useless because it relies on references to transactions that have become extinct.[122]

Within this vertical integration, there are three trading models which a multinational bank can adopt: the centralised product management model; separate entity model; and functionally fully integrated model (integrated trading model).[123] The models can be represented along a continuum: the integrated trading model at one end, centralised product management model in the middle and the separate trading model at the opposite end.[124] A multinational bank may use a combination of these models according to the various services offered and products being traded.

The integrated trading model has traders in separate international jurisdictions trading off the same portfolio of positions. This is what is known as a "book", the responsibility for

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[117] Casson, n 82, p 154.

[118] Casson points out that the vertical linkages may have the appearance of horizontal integration: Casson, n 82.

[119] Teece DJ, "Multi-national Enterprise, Internal Governance, and Industrial Organisation" in Teece DJ, *Economic Performance and the Theory of the Firm: The Selected Papers of David Teece* (Edward Elgar Publishing, 1998).

[120] Lebowitz, n 28 at 1203.

[121] Lebowitz, n 28 at 1203.

[122] Lebowitz, n 28 at 1203.

[123] Snyder A, "Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-split Methodology" (1995) 48 Tax Law 1057 at 1058.

[124] OECD, n 13, p 19(para 48).

which is passed from one location to the next as the market closes in one jurisdiction and opens in the next. The integrated trading model is a true global trading model.[125] The primary concern of the multinational bank operating under the integrated trading model is the time zone. Essentially, all functions can be performed in any of the multinational bank's locations and, at any given time, will be performed where the market is open. At one time this type of model was regarded the exception rather than the norm, but it is now becoming the more prevalent mode of operation.[126]

The centralised product management model has a central location accepting and managing all risk associated with a particular product with separate branches managing separate products. Various commercial factors, such as market liquidity, ease of hedging, competition, business strategy, location of customers and skilled staff, influence the location of the centralised trading site.[127] This centralised trading site is essentially a head office into which all other parts of the entity report.

The separate enterprise model has each location operating as if it were a separate profit centre. Under this model, each location, whether a subsidiary or branch, has its own marketers and traders and its own books reflecting the activities of that location.[128] Provided the branch or subsidiary does not trade outside its trading limits, the central committee will not control any transactions undertaken by the individual locations.

No matter which model is adopted, global trading operations within financial intermediaries perform four general functions: trading, sales, management and support.[129] These four elements of the structure introduce their own unique qualities. On one hand, trading is divided into product groups, rather than geographical locations, with traders being rewarded on profitability as a whole. Management, on the other hand, may have responsibilities restricted to product, clients, economic sectors or particular markets. Sales staff will generally be responsible for a portfolio of clients and, as such, are cross-jurisdictional. Finally, the support team are responsible for the integrated entity as a whole, primarily offering support to ensure that global transactions are accomplished.

These trading models not only distinguish the multinational bank from its more traditional counterparts but also raise unique tax problems. Again, both source issues and transfer pricing issues arise. First, even if the legal source is easy to ascertain, given the three alternate trading models, it is argued that this may not be the economic source of the income. Secondly, transfer pricing issues arise because of the highly integrated nature of the models and the lack of comparable independent third party transactions.

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[125] White R, "Global Trading – Carving Up the Profit Cake" (1997) 24 TPIR 21 at 22.

[126] Snyder, n 123 at 1058.

[127] OECD, n 13, p 20(para 55).

[128] OECD, n 13, p 20(para 60).

[129] Snyder, n 123 at 1058.

5.3 Servicing clients through appropriate locations

The final characteristic of the multinational bank, which differentiates its organisational structure from traditional multinational entities, is location. Multinational banks are more likely to be concerned with servicing time zones rather than geographical locations.[130] This is because a multinational bank is concerned with ensuring that a part of its organisation is always operating.[131] Banks will also be managed along the lines of products rather than along geographical boundaries.[132] Consequentially, it is suggested that tax rules based on such geographical locations is inconsistent with the objectives of the multinational bank.

Despite this concern with time zones, multinational banks need to be geographically located. The choice of location, however, is also grounds for concluding that multinational banks are unique. There are two reasons for the location of banks being distinct from that of manufacturing industries. The first reason is that commercial (deposit) banks need to be located where the customer resides. The second reason is that trade banks and investment banks need to be located in just a few centres, but those which are major financial centres. For example, a multinational bank will usually have offices operating in New York, London and Tokyo.[133] Essentially, because a bank is providing services rather than goods, it is easier to have fewer offices dispensing services across a larger area than to have numerous offices each servicing smaller regions. Provided there is representation in each time zone, a client can be fully serviced.

6 A POSSIBLE SOLUTION?

The unique differences between traditional multinational entities and multinational banks mean there may be the need for a distinct international tax regime for the taxation result to reflect economic reality. An examination of the unique nature of multinational banks leads to the conclusion that the appropriate tax treatment of these banks may be different from the appropriate tax treatment of multinational entities more generally. While it is not the purpose of this article to critique an alternative taxation model, one such model is suggested as an alternative that is worthy of further investigation.

An alternative to the current regime taxing multinational banks that may be investigated in the future is unitary taxation based on global formulary apportionment. It may be argued that this is a theoretically superior model that would tax multinational banks in a manner reflecting economic reality. Unitary taxation is the taxation of the worldwide income of a multinational entity and is normally based on a formulary apportionment method, which

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[130] Shelton JR, "Emerging Issues in Taxing Business in a Global Economy" (1997) 14 Tax Notes Int'l 221 at 222.

[131] Although as Dr Chia points out that "in the 1950s, the comparative advantage of the financial centres depended crucially on the location advantage of favourable time zones. Today, many financial transactions are not limited by conventional business hours and can be carried out instantaneously 24 hours a day": Chia NC, "Trends in Tax Structures and Fiscal Policy Issues in the New Millennium" (2000) 6 APTB 107.

[132] Levey MM, "Proposed 482 Regs. Attached at Hearings; Two Banks sign APAs" (1992) 3 JOIT 248.

[133] Plambeck, n 8 at 1133. A majority also operate in Hong Kong, Sydney, Zurich, Chicago, Singapore and Toronto.

allocates income to the relevant jurisdictions based on a percentage of the worldwide profits of the multinational entity.[134]

Formulary apportionment does not solve all of the issues associated with the current international tax rules governing jurisdiction and allocation of income.[135] It does remain, however, a potential solution to many of the problems associated with the separate entity approach[136] and recognises the consequences of globalisation by multinational entities.[137] Principally, it removes the requirement to identify and price internal transactions.[138] Furthermore, it provides a complete solution to the issue of allocation of profits between relevant jurisdictions where there is international acceptance of this model.[139] As such, many of the issues which arise in the context of multinational banking may be resolved through a unitary tax model.

When the unitary tax model based on global formulary apportionment is applied to multinational banks, it has several interrelated theoretical advantages over the existing arm's length model. The most significant advantage to global formulary apportionment is that, because multinational banks are highly integrated, unitary taxation has greater consistency with economic reality. Unitary taxation also conforms to the aim of efficient operations within the multinational bank, providing the advantage of consistency between bank policy and tax policy. Further, formulary apportionment has the theoretical advantage of aspiring to the aim of finding an equitable split of profits between the jurisdictions which should ultimately be the overall aim of any taxation regime.[140] There are also consequential practical advantages arising out of the implementation of unitary taxation based on formulary apportionment. As such, this model is worthy of further consideration.

7 CONCLUSION

It has been demonstrated that multinational banks, as a subset of multinational entities, have grown due to the demand generated by their multinational entity clients and due to their internalisation and capitalisation of valuable client-relationship information. Such growth has primarily been in the form of foreign direct investment which, under the defensive expansion approach, allows banks to have ownership and control in foreign markets. It is this vertical foreign direct investment structure, often in locations based on time zones rather

[134] Eden, n 23, p 36.

[135] Coffill EJ and Prentiss W Jr, "Federal Formulary Apportionment as an Alternative to ALP: From the Frying Pan to the Fire" (1993) 59 *Tax Notes* 1103 at 1116.

[136] Graetz, n 5 at 1420-1421.

[137] Avery Jones JF, "Are Tax Treaties Necessary" (1999) 53 Tax L Rev 1 at 37.

[138] Weiner JM, "The European Union and Formula Apportionment: Caveat Emptor" (2001) 41 *European Taxation* 380 at 381.

[139] OECD, n 22, para 3.73.

[140] Green, n 1 at 67.

than geographical zones, in conjunction with the unique nature of their services and the associated monopolistic advantages and network linkages, which distinguishes multinational banks from traditional multinational entities. This distinction is particularly poignant in relation to taxation issues of source and transfer pricing.

The unique character traits and structure of multinational banks provides the platform for an examination concerning the appropriateness to multinational banks of the current tax rules of jurisdiction and allocation, and the current economic assumptions surrounding the taxation of multinational entities. This examination of the multinational bank within an economic framework facilitates a consideration of how these entities should be taxed, and whether, due to their unique character traits and structure, multinational banks should be subject to a different tax regime than traditional multinational entities.

This article concludes that a separate tax regime for multinational banks should be investigated and offers unitary taxation based on global formulary apportionment as one possible solution.